

22 October 1959

MEMORANDUM FOR: Deputy Director/Intelligence
THROUGH: Assistant Director, Research and Reports
SUBJECT: Comments on Speech by Mr. Staats "National Security and Economic Growth"

The attached comments were given verbally to Mr. Carey of Mr. Staats office this afternoon, 22 October. I believe Mr. Carey accepted all of them and they will be incorporated in a revision of the October 14 draft.

STATINTL



Chief, Economic Research Area

OMB Waiver Letter In ERU File

NATIONAL SECURITY AND ECONOMIC GROWTH

Perhaps it would be best to begin by making sure that we all have the same understanding of the term "national security" in the context of the observations I shall make today. I shall not be speaking of it in the limiting sense of direct military programs, but in the much broader framework of our total posture in confronting the versatile challenge of communism. For it is essential not only that we recognize this basic versatility of communism's program, but also that we view our national security problem in equally versatile terms.

I wonder if you were struck, as I was, by the recent observations of Walter Lippmann with respect to Khrushchev's visit. Let me read three short paragraphs from Lippmann's column of September 17:

"Mr. K. is the chief adversary of the United States. He has come here to talk seriously with the President, and to persuade the American people that while he is their challenger, their rival and their competitor, he is not their enemy. He is not bent on destroying them but on outdoing them in all fields of intellectual endeavor.

"This is a sobering prospect, and it cannot be said that Mr. Khrushchev is concealing the seriousness of the challenge which he poses. For the true inwardness of this challenge is aimed directly at the critical weakness of our society.

"The critical weakness of our society is that for the time being our people do not have great purposes which they are united in wanting to achieve. The public mood of the country is defensive, to hold on and to conserve, not to push forward and create. We talk about ourselves these

days as if we were a completed society, one which has achieved its purposes, and has no further great business to transact."

Coming from a thoughtful American, this is severe criticism. In my own view, it goes too far. We have by no means lost our spirit of enterprise, but we can and should ask ourselves whether we are making the most of it. This has a bearing on what we are considering here today. National security can't be bought solely with huge appropriations for deterrent power, nor assured by dramatic demonstrations in outer space, nor exorcised by a blind belief that communism must inevitably meet a bad end. What we are for is even more pertinent than what we are against. With this goes the issue of how a free society in the present age goes at the job of defining its objectives, calculating the costs and the sacrifices, and ordering its resources to produce the desired results. Or, as Lippmann puts it, the task is to rediscover our "great purposes," and unite in achieving them.

The Soviet offensive

For the first decade or so of the cold war, we were preoccupied with the military and ideological aspects of the Soviet threat. Then, and rather suddenly, we were made aware of unexpected Soviet drives in science, education, and industrialization. Now the threat takes a decisive new form, articulated by Mr. Khrushchev himself in his celebrated declaration of economic competition within the framework of coexistence. I think we understand the workings of the communist society well enough to be sure that there will be no lessening of collateral pressures on the free world, even though the propaganda emphasis may now be weighted toward competitive economics. The Soviet offensive will continue to be versatile in its

character and in its techniques.

Yet, the buildup in economic competition cannot be discounted, if for no other reason than that it is basic to communism's strong appeal to the have-nots of the world in the sense of holding out the promise of a better way of life. The longstanding leadership of the United States in economic progress has been a factor which we have taken for granted in international politics. Now we are being challenged by communism's determination to overhaul us and surpass us, and we must not fail to recognize that this is a matter of no small importance to the subject we are here to consider today, namely, our national security.

We could spend the whole morning reviewing comparative statistics on Soviet vs. U. S. economic growth. The Soviets, with a Gross National Product roughly 40 percent of ours, have recently been advancing at an average annual rate two or three times greater than our own 3 to 3½ percent. They aim to catch up with us in output by 1965, and forge ahead by 1970. I think it is important that we recognize that their recent remarkable progress has been concentrated in basic industries and agriculture; and that we are in no sense comparing simultaneous performance by two evenly-matched industrial systems. They are going through a stage of industrial expansion that lies in our past record, and they are progressing from a starting-point that in no way reflects the situation in which we find ourselves as a fully-developed industrial society. Moreover, as someone has pointed out, their goal of outproducing us by 1970 seems to require that our own growth rate will slip back to about two percent a year, which is certainly an assumption we are not obliged to swallow. Still, while we may be skeptical as to the Soviets' economic timetable, we have to face the

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possibility that, in time, the U. S. and the Soviets could be more closely balanced in aggregate productive potential.

This is a sobering prospect. Given the plentiful natural resources with which the Soviets can back up their coming industrial power, and recognizing the cold-blooded managerial determinism which they can bring to the utilization of these resources, their system presents formidable aspects. Still, we must remember that Gross National Product is not necessarily a qualitative indicator of economic growth or balance. It is an expression of aggregates, and comparisons made in those terms can be very misleading. Measures of raw economic power, imperfect as they are, are no basis for predicting the long-term appeal of a particular system of economics as the most hopeful basis of social progress and human fulfillment.

A great difference in the two systems is, of course, the role of public policy as the prime mover in economic development. In the Soviet system, public policy has decreed the hard measures which have provided the resources for enormous public investment in heavy industry, along with a standard of austere deprivation in other categories of production. Prices, wages, working conditions, earnings, the levels of industrial investment, and taxes are all settled at the level of public policy. I hardly need to say that this gives the Soviets a strategic advantage that we both lack and have no disposition to emulate. Except for periods of wartime mobilization, public policy in the United States has not chosen to set aside the system of private choice, competitive bargaining, and free market forces which characterize the process of economic development under capitalism.

Still another fact which must be remembered in assessing the Soviets' recent growth rate is that they have taken full advantage of the accumulated technological progress of the West. It has been possible for them to profit in the short run from the trial-and-error experience of the free-enterprise system over a whole century. Professor Walt Rostow, in his Economist papers on growth, sheds a historical perspective in this regard, and I quote him: "Once the United States and continental western Europe had completed their take-off, much of the British lead was gone; for they could bring the backlog of technology to bear more rapidly than it had been created. The story is being repeated now as Russia closes the technological gap on the West; China, India, Brazil and others promise to repeat the trick again on the older mature powers, including Russia, in the next half-century or so."

Greater maturity and further advances in production will plant the seeds of slower growth in other ways as well. The rapid growth of Soviet output to date has been accompanied by better utilization of manpower--particularly transfers from agriculture to heavy industry. This cannot be continued indefinitely at as high a rate. Also, Soviet authorities have been finding it increasingly difficult to keep consumption goals as low a proportion of total output as the planners might desire. Evidence accumulated to date (or published recently by the Joint Economic Committee) indicates that the Soviet annual growth rate has in fact slowed significantly in comparison with the rates in the immediate postwar period.

After we have said all this, the unpleasant fact remains that we have our work cut out for us. The problem we face is to develop a greater awareness of the real meaning of the Soviet undertaking, and an equal

awareness of our own national purposes in responding to it.

What should our goal be? Here we encounter differences of opinion. One approach holds that we should step up our annual rate of output to match the recent rates achieved by the Soviets. This would mean something between two and three times our present annual growth rate. Another choice might be to aim for a consistent annual rate of 5 percent. A third alternative is to regard our present rate of output as representative of the natural effort of our system to achieve expansion. Such aggregative numerical goals are meaningless to almost everyone. The range of alternatives is such that 2 percent growth of a certain kind can provide more industrial strength and capacity than 5 percent growth of some other kind.

I think it should be clear that we must not be stampeded into a pattern of forced expansion simply for the sake of "keeping up with the Khrushchevs." Some of us remember that not very many months ago we slid into a recession which some leading economists blamed upon a fling with over-expansion of capacity and inventories. That should have taught us some lessons, because it led to business failures, unemployment, lost earnings and profits, and a certain amount of worry around the world as to the degree of stability in our economic system. It is interesting to note, by the way, that we slipped off into that particular decline at the crest of a period of expansion in which the annual growth in the dollar value of GNP had been 5 percent. Whether there was a cause-and-effect relationship is a matter for speculation, but the coincidence is an interesting one. Certainly, long-run growth will be aided by minimizing economic fluctuations and inflation.

To achieve, in the short run, a doubling or tripling of our annual rate of growth could call for governmental intervention in the private economy on a scale unprecedented in peacetime. We might have to return to wartime production control measures, together with a price and wage stabilisation system to avoid disastrous inflation. You might reply that this is exactly what we have to do, since we are in reality fighting a dollar and ruble war. But there is more to the issue than this alone. The contest that the world is watching is that of a dictated economy versus a private-enterprise economy. That is the point that we must not forget. Somehow, we have to work our way out on a basis that proves that a private-enterprise system can achieve sustained and striking growth under its own momentum, without becoming an instrument of thinly-disguised governmental management and regulation.

Secretary Anderson recently summed up the situation, when he said "While Government cannot force growth in a free economy, it can do much to promote sound, sustainable economic progress." And he suggests that we look behind the broad measures of asserted growth, such as GNP, to ask such questions as these:

"When growth has taken place, how much did consumption expand relative to Government use of goods and services? How much of the Government portion consisted of military hardware as opposed to schools, highways, and other public facilities? How much of the output was composed of goods that people did not want--goods which ended up in Government warehouses, being given away, destroyed, or sold for less than true value? What portion of total output was devoted to enlargement and modernization of business plant and equipment and to research? ... How were the fruits of the growth in output

distributed among various groups in the economy? Was the growth characterized by distortions and imbalances that would hamper future growth? To what extent was temporary growth stimulated by actions that impinged on the free choice of individuals and institutions?"

In short, we are not to be misled by the illusion of growth, but rather, concentrate on the reality. And in this process of critical appraisal, let's be candid enough to ask whether Government's part in creating what passes for growth is all that we sometimes take for granted.

The U. S. and Soviet budgets: the problem of comparability

It is probably inevitable that the alarmists who see us being "overtaken" in the area of economic growth, as we supposedly have been overtaken in the areas of science, education, and missiles, will seize upon the Government's budget policy as a factor influencing our economic fortunes, or misfortunes.

These critics have a field day when the annual Soviet "budget" is made public. They take particular pains to compare the claimed Soviet allocations to education, science, and public health with our own budgetary plans, and the comparison is invariably odious. But the problem of comparability in the two budgets is actually very frustrating. The Soviet budget, as we get it, consists of perhaps two sheets of figures under very generalized headings, and even our intelligence community leans over backward to point out that the official budget of the Soviet Government cannot be taken at anything resembling face value.

The Soviet budget, like all other expressions of Soviet policy, borders on the inscrutable. The significance of specific appropriations can only be guessed at from comparison of changes from other years. We can't even

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accept as meaningful the relative size of individual budget items, without considering whether some costs (as for military measures) may be charged to some different category such as science or education or industrial development. The translation of ruble appropriations into dollar equivalents is equally fruitless because of the continual variations in purchasing power of the ruble among the various sectors of consumer goods, industrial investment and defense. Moreover, you get one result if you use the official ruble-dollar exchange rate of four-to-one, and quite another if you use the unofficial rates.

An even greater barrier to comparison of the Soviet and U. S. budgets arises from the extreme differences in the construction of the two budgets. The Soviet budget covers the majority of investment outlays, the planning and administration of the economy, and education, whereas these activities are largely financed in the U. S. by private enterprise, private institutions, and State or local governments. In short, the Soviet budget is a reflection of what our own budget might look like if it contained the expenditures of our private economy, plus the State and local governments, plus the Federal Government itself. Comparability between the two budgets, therefore, is practically impossible in the absence of access to the real national accounts which are employed by the Soviets.

I doubt, for instance, that any of us would take seriously the Soviet budget's apparent provision for defense, which indicates that these expenditures amount only to 15 percent of the whole budget, as compared with about 60 percent in the United States. Here we are up against a problem in propaganda, in part, and also a problem in classification of expenditures. The Soviet budget definition of defense expenditures is narrower than our

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own, apparently, and we would have to look inside quite a few budgetary haystacks to find the outlays for munitions factories, military research and development, and even the nuclear energy program. For example, their outlays for military research are probably hidden under educational expenditures plus a contribution from enterprise funds. Programs for nuclear energy might have to be tracked down as a part of the expenditures for financing research institutions.^{The national economy} In short, my guess would be that the official budget entry for Soviet defense is very considerably understated, and by the same token, the *prima facie* meaning of every other budget entry is inherently questionable.

We know that it takes plenty of money, whether dollars or rubles, to support a huge military enterprise. Director Dulles of CIA, in a recent public address, pointed out that the Soviet Union maintains an army of 2½ million men. He stated that the Soviet Army has been fully re-equipped with modern guns, tanks, and artillery. He has reason to believe that the Soviet army has been trained in the use of tactical nuclear weapons. In addition, they have modern airplanes and a large number of submarines, and we know that they have channeled a large effort into space vehicles and rocketry.

All the indications are, in fact, that the burden of armaments in the Soviet Union comprehends a larger relative percentage of their GNP than they can stand and still accomplish their objective of economic development. It is no wonder that, under these conditions, their industrial growth has been achieved in stark circumstances, and that the current Soviet policy is to pursue the pragmatic objective of a thaw in foreign relations.

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I hope that what I have said here today as to the acute difficulties and hazards of comparing the Soviet budget with our own will have the effect of stimulating much more in the way of strenuous research into this problem of comparability. If it accomplishes nothing more than to catalog the differences which obstruct objective comparisons, it will have been worthwhile. By the same token, it should serve to put a damper on irresponsible criticism of our own budgetary policies.

Growth and budget policy

Now, let's deal with the question of whether, assuming that we do not want forced governmental growth with the resulting unacceptable consequences, the present budget and fiscal policy of the Federal Government is consistent with the Nation's need for growth. A highly vocal sector among the country's economists have said flatly that our present budget policy is leading to stagnation and not growth. Boiled down, their complaint is that the goal of a balanced budget has been allowed to become a paramount aspect of public policy with the result that needed expenditures beyond foreseeable revenues are inadmissible regardless of merit. They contend that needs are needs, after all, and that our economic system can afford to meet them squarely. Some say the needs should be met even though budget deficits may result. What they are contending is, of course, that deficit spending will promote economic activity and hence create new wealth and well-being, while incidentally augmenting tax revenues. This is what was once known as the doctrine of spending oneself into prosperity. It dies a hard death.

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The short and merciful answer to all this is to look at where we stand today, after 24 deficits in the past thirty years. Our public debt is \$295 billion, well over half of our annual GNP equivalent. The cost of paying interest on the money that has been borrowed by the Federal Government is running over \$9 billion in the annual budget, and from the way things look now, it will be even higher in future years as the Treasury is obliged to compete for short-term refinancing at high rates of interest. In the past year, there has been evidence of growing disinterest on the part of investors in Government bonds. I cannot bring myself to believe that the Nation's interest in sound economic growth would be served best by compounding the problems of mounting debt, crushing interest charges, imperiled public credit, and inflation.

Other critics of our present budget policy are willing to pay higher taxes for an increase in Government services. But the taxing potential is not unlimited. We need to preserve incentive in our kind of system, and we cannot increase the Government share of the economy indefinitely without prejudicing private initiative and investment opportunities.

I agree, on the other hand, that we find ourselves with a real domestic problem which we might call the "Budget Gap." This is a short description for the mounting list of unmet social needs beyond the capacities of today's Federal tax and expenditure system. On the taxing side, there are limits to the Treasury's income under present law, partly because of the structure of exemptions, credits, and enforcement techniques. In the expenditure side, most of the available money goes for defense, subsidies of various kinds, and the payment of interest to the Government's creditors. Between the two prongs of the pincers, it is manifestly hard

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to find sufficient flexibility to permit new programs to get into the budget.

If course, something can be done to relieve this inflexibility. The Congress is already manifesting considerable interest in an overhaul of the tax structure. On the expenditure side, the President has made 18 broad recommendations to the Congress for statutory revision of the basis on which benefit and subsidy programs are now authorized. Nevertheless, this is a slow and painful process, and to date we have little that we can point to in the way of either sympathy or results.

If we are unwilling to be taxed beyond present rates in order to pay for what we think important, and if we are equally unprepared to get rid of some of the subsidy operations which now eat up our taxes, then we have no choice but to either postpone new programs or dig ourselves into an even deeper financial hole through deficits and bigger debts. Call it what you will, but I don't believe you can properly call it progress. I feel more and more convinced that the budget today is saddled with yesterday's priorities rather than tomorrow's; and if the Soviet's challenge means anything, it certainly means that we had better start thinking in terms of tomorrow. For their own part, they are running as fast as they can from the past, in order to be first for the future, and I think we all hope that they'll find us already there when they arrive. But it isn't going to happen that way unless we get busy in a hurry.

I hope you will think about these considerations when you form your opinions on the question of what share of our resources should be allocated to national defense and how these resources should be allocated within the defense total. At the present time, about 60 percent of the Government's

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budget goes to this category of expenditure. That's a large bite, both absolutely and relatively. And yet, we could doubtless allocate significantly larger sums to national defense programs, if we felt that they were required. Of course, what we spend for defense can't be spent for anything else. From the standpoint of the whole spectrum of national needs, our budget is certainly unevenly allocated.

But national defense is only one component of national security. We cannot afford to concentrate on weapons to the practical exclusion of the other dimensions of the threat of communism. We are being challenged not only militarily, but as well in education, in science, in technology, in agriculture, in trade, in medicine, and in the villages and native councils of peoples and races which are only now awakening to the existence of modern civilization. Our national security is a many-faceted proposition, but at its root is the proposition of a healthy private-enterprise economy. Within that primary objective, it should be possible to make a balanced provision for the national defense, whether it ends up at 60 percent or some other relative measure in the total budget. In arriving at that decision, we must look outward at the whole range of our responsibilities in the world, and not merely inwardly to the maximum satisfaction of certain standards of military capability.

And so I return again to the challenge of economic growth, and what we can do about it in order to safeguard our national security. Our hope lies, I believe, in the standards we adopt to govern the efficient and continuous use of our economic resources. First of all, we must allow breathing-room for the process of capital formation in order to maintain a strong incentive for enterprise. This means avoidance of oppressive

taxing policies, and equally the restraint of price and wage inflation. Secondly, we must stop the present strain on the budget which is represented by the rise in the public debt and its associated costs in interest and depreciated public credit. Third, we must devise, in the tradition of a free society conscious of its responsibilities, a system for determining priorities among the many social needs, so that our public policy can be rebuilt to fit the desperate contest which lies just ahead, for it is only in this way that we can free ourselves of the accumulation of distractions which obscure the vision we must achieve. And if we do these things well, we will find, I believe, that growth under free enterprise is by no means the improbability that Mr. Khrushchev would like us to believe it.

The essence of the half-century which lies ahead, in my view, is not an exhausting bi-national competition for economic growth, but much more likely a comparative demonstration of the respective capacities of two dissimilar societies to advance productively and creatively in the economic sphere in a setting of stability. That is the goal: growth with stability. And for whom is this demonstration to be staged? That, too, is clear, for in this century of technological awakening the whole world is the audience, and industrial growth is destined to be widely, perhaps universally, shared. In this sense, the concept of our national security takes on a broader meaning, signifying the quality of a particular social system, based on free enterprise, the Christian ethic, and the rule of law, to endure in circumstances that today we find it difficult to visualize with much clarity. The externals of that system may change often and markedly, but if its inner foundations are built well, its chances for endurance are strong. A moving index of productivity is hardly the north

star by which we should navigate, however luminous its trail may be. Far more imperative a standard on which to grow, with stability and order, is the ability to look critically at how we are employing our resources, and, even more deeply, to decide to what great purposes we wish to allocate those resources. That is the key. We must not behave as though we were "a completed society, with no further great business to transact."

Let me end with this further thought from Walt Rostow: "The problem posed by Russia lies not in any uniqueness of its story of modernization, but in the question whether the West can mobilize its ample resources to do the jobs that must be done--resources of the spirit, intellect, will and insight quite as much as steel and electronic gadgets; jobs which extend not only to missile arsenals but to the Indian five-year plans and the far reaches of the British Commonwealth. The puzzle lies not in the mysterious East, but in the inscrutable West."